WEEKLY ECONOMIC UPDATE

1 – 7 September 2014

Information about intrusion of Russian troops into Ukraine caused that investors focused again on geopolitical risk, which has remained in the background in recent weeks. As a result, risk aversion has grown and EM assets, including Polish zloty and bonds, suffered a clear correction. Slightly better than forecast domestic data about retail sales and GDP growth did not influence market moods significantly.

Situation in Ukraine will remain in focus of attention. Moreover, crucial events of this week in Poland and abroad will be central banks' decisions. In our opinion MPC will not cut interest rates at the nearest meeting, which may create impulse for longer correction on Polish debt market, but on the other hand the tone of the statement should support expectation that the cut is likely in near future. Keeping the interest rates unchanged can also trigger a rebound of the zloty and the EURPLN may try to return below 4.20 (it will depend on the situation in Ukraine, tough). Meanwhile, PMI release can negatively influence the domestic currency at the start of the week. Change of Prime Minister in case of Donald Tusk's appointment for the President of European Council can be also a factor temporarily fuelling uncertainty on the domestic market after the weekend.

Economic calendar

CZAS W-WA	COUNTRY	INDICATOR	PERIOD		FORECAST MARKET	FORECAST BZWBK	LAST VALUE
		MONDAY (1 September)					
3:45	CN	PMI-manufacturing	Aug	pts	-	-	51.7
8:00	DE	GDP	Q2	%YoY	0.8	-	2.5
9:00	**PL**	**PMI-manufacturing**	**Aug**	**pts**	**49.0**	**49.0**	**49.4**
9:55	DE	PMI-manufacturing	Aug	pts	52.0	-	52.4
10:00	EZ	PMI-manufacturing	Aug	pts	50.8	-	51.8
		TUESDAY (2 September)					
16:00	US	ISM-manufacturing	Aug	pts	56.9	-	57.1
		WEDNESDAY (3 September)					
	PL	**MPC decision**		**%**	**2.50**	**2.50**	**2.50**
9:00	HU	GDP	Q2	%YoY	3.9	-	3.5
9:55	DE	PMI-services	Aug	pts	56.4	-	56.7
10:00	EZ	PMI-services	Aug	pts	53.5	-	54.2
11:00	EZ	Preliminary GDP	Q2	%YoY	0.7	-	0.9
16:00	US	Industrial orders	Jul	%MoM	11.0	-	1.1
20:00	US	Fed Beige Book					
		THURSDAY (4 September)					
11:00	**PL**	**Bond auction WZ0124/DS0725 worth PLN 1-3bn**					
13:45	EZ	ECB decision		%	0.15	-	0.15
14:15	US	ADP report	Aug	k	209	-	218
14:30	US	Initial jobless claims	week	k	299	-	299
16:00	US	ISM-services	Aug	pts	57.6	-	58.7
		FRIDAY (5 September)					
8:00	DE	Industrial output	Jul	%MoM	0.5	-	0.3
14:30	US	Non-farm payrolls	Aug	k	220	-	209
14:30	US	Unemployment rate	Aug	%	6.1	-	6.2

Source: BZ WBK, Reuters, Bloomberg

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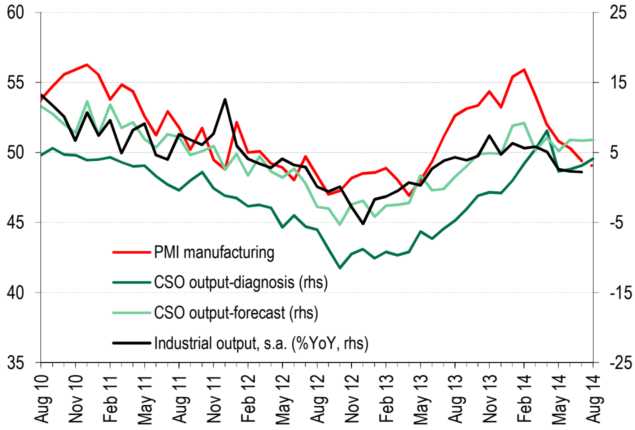
What's hot this week – MPC likely to wait with interest rate cut

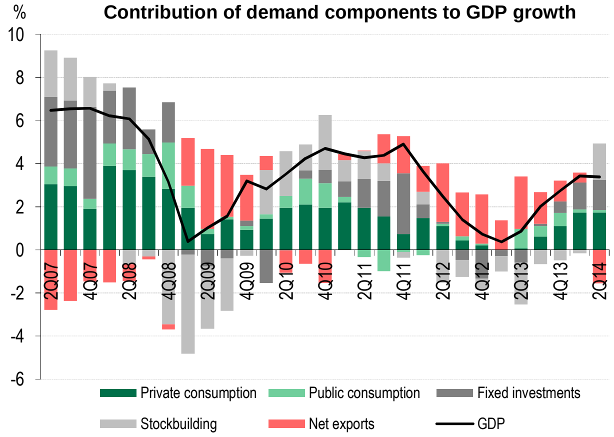
Industrial output and business climate indicators



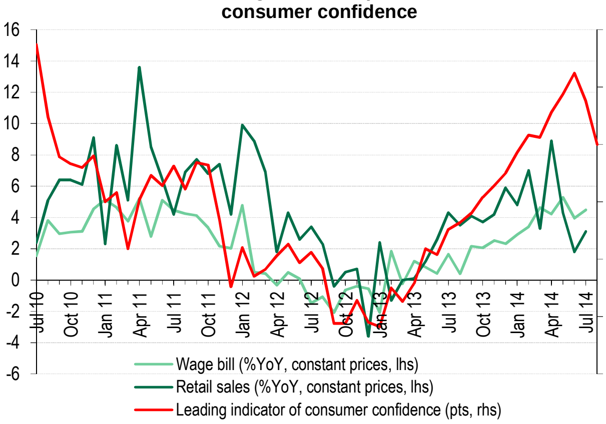
- Decline of industrial activity indices in August in the Eurozone, including Germany, does not bode well for economic situation in Polish industry. Seasonally adjusted CSO's business climate index for manufacturing also declined slightly, but, interestingly, the report shows decent assessment of production volume. We assume that the Polish PMI will drop again, to 49pts, pointing to at further weakening of activity in industry.
- At a MPC's first decision-making meeting after summer-break the discussion about rate cuts will probably take place. In our view, information which appeared in last two months changed the macro scenario to the extent that monetary policy easing is justified. We think that in September there will be still no majority of votes to support a rate cut, but the rates will be lowered in total by 75bp till November.

Last week in the economy – Second quarter not so bad, but next may be worse

Contribution of demand components to GDP growth



Retail sales, wage bill in corporate sector and consumer confidence



- GDP growth reached 3.3%YoY in 2Q14, a notch higher than the flash estimate 3.2%YoY. Private consumption growth accelerated to 2.8%YoY, in line with our forecast, while fixed investments delivered a big positive surprise, rising 8.4%YoY, well above our expectations. It appears that a surge in investment spending in 1Q14 by almost 11%YoY was to much lower degree than we assumed boosted by one-off effects (very good weather, temporary tax allowances). Total domestic demand soared 5.1%YoY, at fastest pace since the end of 2010, but to large extent it resulted from low base effect in inventories, which added 17pp to GDP growth. Next quarters will probably see GDP growth sliding below 3%YoY, amid decelerating external demand and no significant boost in domestic market.
- Retail sales growth accelerated in July to 2.1%YoY. We think that better result may be to some extent connected with very good weather in July, which caused that more people spent their holidays in Poland rather than going abroad. On top of that we had higher than expected sales of motor vehicles. The data did not change substantially the outlook for the coming months – we expect slightly higher sales growth, as consumer demand is still supported by gradually rising real households' income. On the other hand, waning pace of improvement in the labour market and rising uncertainty (falling consumer confidence) will limit consumer confidence to some extent.
- Unemployment rate fell in July to 11.9%, and next few months may see its stabilisation (before seasonal rise slightly above 12% at the year-end).
- In general, the set of economic data released in the recent weeks reduced optimism regarding GDP and we think it can fall below 3% YoY in the second half of the year.

Quote of the week – More money for pensioners and families with children

Donald Tusk, Prime Minister, 27.08, PAP

We will propose accepting variant where we keep percentage pension indexation but simultaneously we will propose introducing indexation equalling to not less than – and a concrete number here. (…) minimal growth of pension indexation would equal to PLN36.

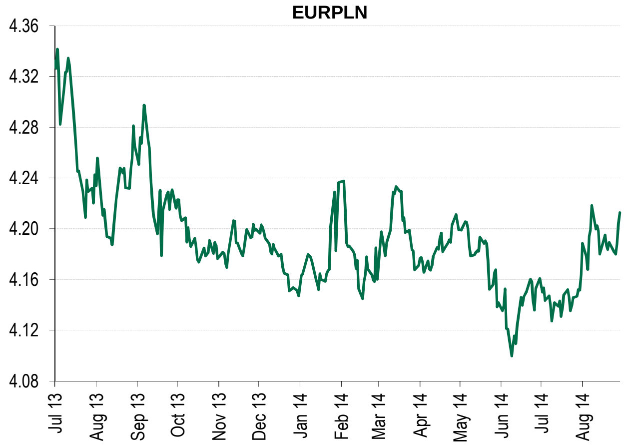
Since this tax year, the government will propose full use of tax deduction for children. The change will consist of possibility of deduction of 100% tax break, which means return of money as far as low income is concerned. (…) 1.2mn Polish families will benefit from the change.

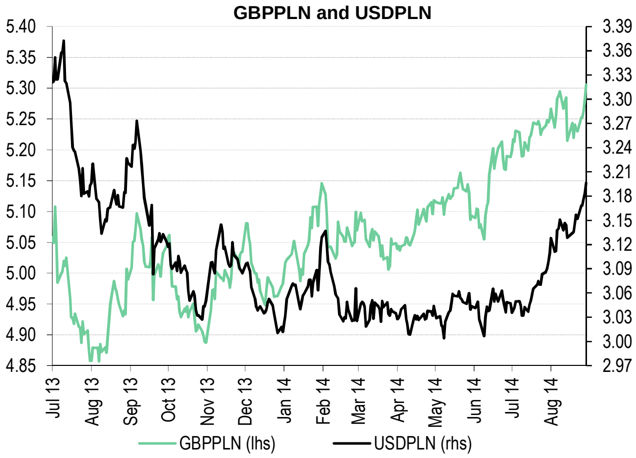
Mateusz Szczurek, Minister of Finance, 27.08, PAP

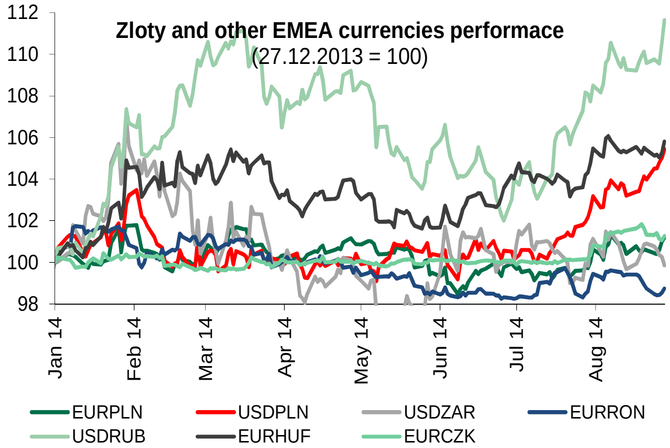
The most important task for 2015 is the budget. (…) In 2015 deficit, calculated with EU standards, will not exceed 3%.

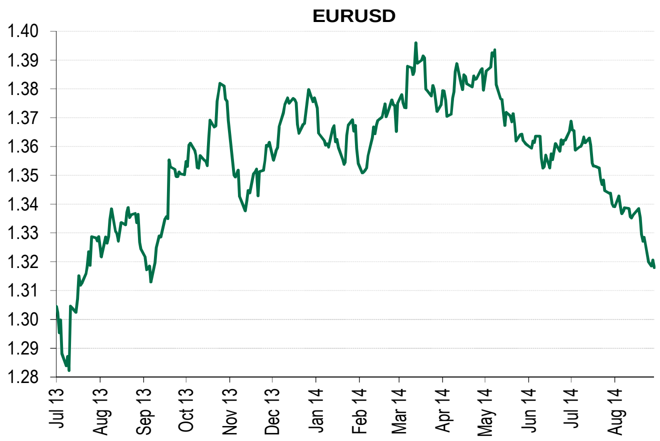
The government's proposals will result in slight stimulation of domestic demand in 2015, as the changes will mostly affect people with relatively low income and high propensity to consume. According to our estimate, the planned change of pension indexation will increase the average pension growth in 2015 by additional 0.5%. Families with children will also benefit slightly. The scale of the impulse (PLN2.8bn, c0.2% of GDP) will not be huge but it will be one of the factors supporting GDP growth next year at c3%, despite probably tough external environment.

Foreign exchange market – Zloty under influence of central banks' decisions









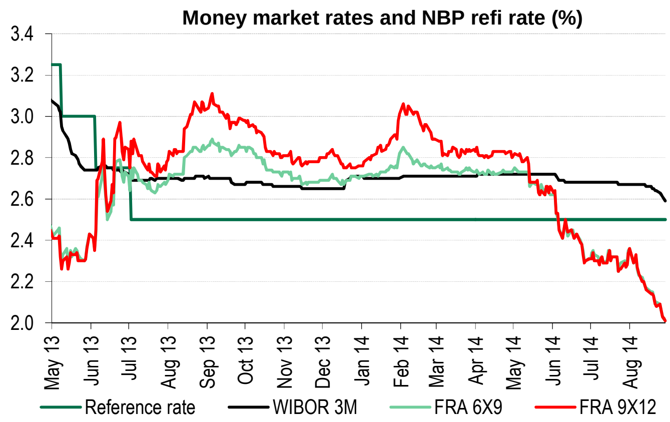
Zloty and other CEE currencies suffered from Ukraine

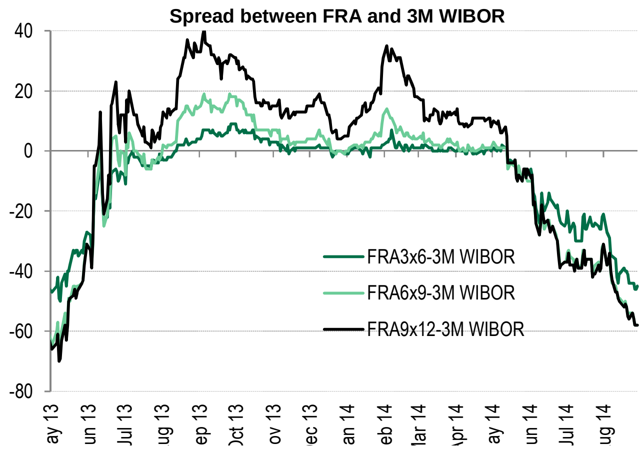
- The beginning of the last week suggested strengthening of EM currencies, including the Polish zloty. Investors' mood improved quite considerably due to expectations for further policy easing by the ECB (after Mario Draghi's speech at the Jackson Hole symposium). As a consequence EURPLN fell temporarily to 4.172, and then quickly returned above 4.18. Information from Ukraine have increased geopolitical risk and caused weakening of the Polish zloty. EURPLN easily broke the resistance level at 4.20 and increased temporarily slightly above 4.23 at the beginning of Friday's session. However, better than expected 2Q14 GDP reading brought the market some relief and the exchange rate returned slightly below 4.22. In weekly terms zloty weakened the most against the British pound and the US dollar (c1.4% on average).
- Other EM currencies also lost due to higher risk aversion. In weekly terms the biggest loss against the euro suffered the Russian rouble (c2%), then the Polish zloty (c0.6%) and the Hungarian forint (0.5%). The Czech koruna trimmed all earlier losses and gained by 0.5% vs euro.
- The Polish zloty, similarly to other EM peers, remains under pressure of situation in Ukraine. Risk of further escalation of conflict may result in the EURPLN testing the resistance level at 4.225 and its breaking will open the room for increase towards 4.25. Possible change of Polish Prime Minister (if Donald Tusk is appointed the governor of European Council) may add more volatility on the market just after the weekend. Besides all these factors, investors will also focus on the central banks decisions (MPC and ECB meetings later this week). Lack of interest rate cut by the MPC should support the zloty rebound and the EURPLN decline below 4.20 (as some investors are betting that monetary policy will be relaxed already in September). However, at the beginning of the week the zloty may suffer from weak PMI indices.
- The ECB decision on Thursday will be the key event for emerging markets' currencies. In our opinion the ECB may abstain from further monetary easing, waiting for results of TLTROs, which starts in September. As a consequence high volatility may return on the market at the end of the week.

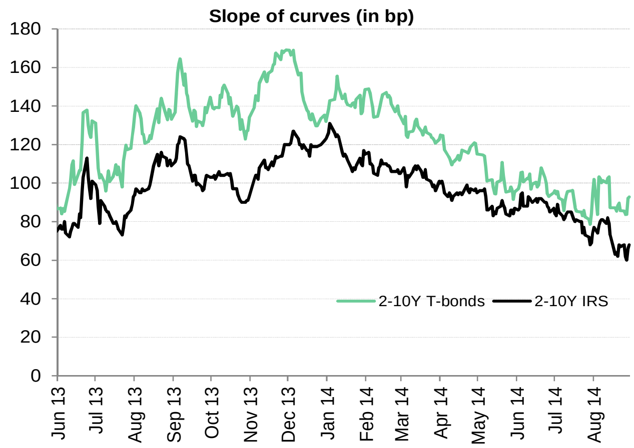
The dollar is supported by risk aversion and the US data

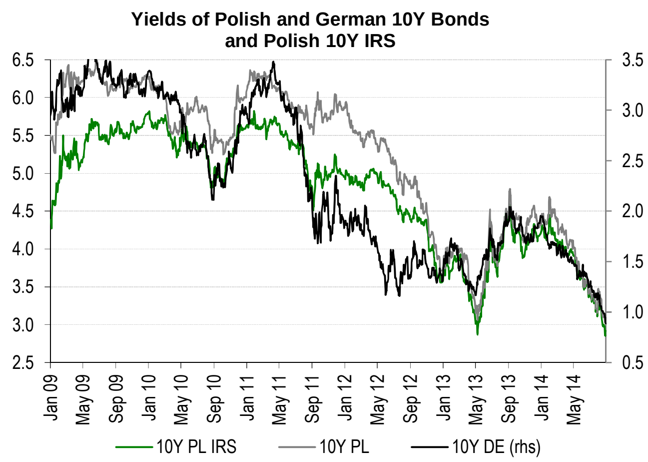
- Last week the US dollar strengthened quite considerably, supported by risk aversion and good macroeconomic data from the US. The second reading of 2Q14 GDP growth surprised the most as the data was revised upwards to 4.2%. Additional factor, which supported the downward trend of the EURUSD, was expectation that the ECB will decide to ease monetary conditions in upcoming months, weak macro data from Germany and political uncertainty in France. Consequently the EURUSD fell to 1.315 (the lowest level this year).
- As a consequence of higher risk aversion capita shifted towards safe-haven assets, including the Swiss franc. It resulted in the EURCHF fall towards 1.20. We think that further decline in the EURCHF is limited as the Swiss central bank may intervene at 1.20, the floor level introduced in September 2011.
- This week is heavy of important macro data releases (PMI and GDP for euro zone, non-farm payrolls in the US) and events (ECB meeting). Further decline in PMI indices for both the euro zone and Germany and continued improvement in economic situation in the US (especially on the labour market) may put pressure on the euro. On the other hand we do not exclude some correction if the ECB refrains from action to stimulate European economy.

Interest rate market – Possible short-term correction









Falling WIBOR in expectation of rate cuts by the MPC

- Recent week saw a decline of all WIBOR rates between 1M and 12M by 1-6bp along the curve. Because of the fact that the decline was the strongest in longest maturities, WIBOR curve flattened significantly (1M-12M spread narrowed to 3bbp from 8bp at the end of the previous week). FRA rates also continued fall despite better than forecast macro data (retail sales and GDP above market expectations). Present FRA quotations show that investors expect fall of interest rates by 50bp in nearest 3 months and by further 25bp in nearest 6 months.
- This week investors' attention will focus on MPC meeting. Some investors anticipate a rate cut already in September so lack of such decision (which is our base-case scenario) can trigger a correction (especially on the FRA market), which should be temporary in our view. Macro data due for release in coming weeks should strengthen expectations for rate cuts in 4Q, which will allow a return of downward trend in the money market rates.

Yields at new record lows

- Strong expectations for MPC's interest rate cuts and for further monetary policy easing by the ECB, as well as strengthening core debt markets, supported a decline of IRS rates and bond yields in Poland. Yield of Polish 10Y bond was temporarily testing 3.0%, the lowest level in history, supported by strengthening of German debt. A rise in global risk aversion due to escalation of Russia-Ukraine conflict gave impulse for correction at the end of the week, mainly in the long end and the belly of the curve. Yield of 10Y bond rose to 3.14%, and then stabilised nearly 3.10% at the very end of the week (and month).
- All above factors supported bullish flattening at the beginning of the week (following situation in core markets) as the long-end gained the most. On the other hand rising risk aversion triggered bearish steepener at the end of the week due to significant weakening of long term instruments, which usually suffer the most from investors' mood deterioration. Consequently, at the end of the week 2-10Y spread widened to 93bp for T-bonds (from 86bp in previous week), while for IRS spread returned to the close level of previous week (c68bp).

Low supply and expectations for rate cuts support debt

- Poland's Ministry of Finance announced that it plans three auctions in September. At the first auction (4.09) the Ministry will offer WZ0124/DS0725 worth of PLN1-3bn, at the second one (18.09) it will buy back WZ0115/PS0415, while at third (25.09) it plans to redeem the USD denominated bonds, maturing in July 2016 up to $400m. It means significant increase of the Ministry activity on primary market this month after one month pause. The offer on the standard auction is relatively low, therefore it should not negatively influence on investors' mood.
- Despite relatively deep correction in last days, we maintain a bullish view on Polish bonds, as we believe the Monetary Policy Council will cut the main interest rates by 75bps (in total) until November. Before that happens, the correction may even deepen, not only due to further escalation of conflict in the Ukraine, but also due to a lack of interest rate cuts at the MPC meeting next Wednesday (as some investors are expecting that monetary policy will be relaxed already in September). In our opinion, the recent market weakening is a good opportunity to accumulate Polish bonds.

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